No. 16308

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

ESTATE OF MARY JANE LITTLE, Deceased, BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, Executors,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR THE PETITIONER.

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BRIEF FOR THE PETITIONER.

Opinion Below.

The opinion of the Tax Court is reported at 30 T. C. No. 98 and at pages 27-43 of the Transcript of Record. References to the opinion herein will be to the pages of the Transcript.

Jurisdiction.

The petition for review [Tr. 45] involves Federal income taxes for the calendar years 1949-1952 both inclusive. Petitioner is the duly appointed and acting Executor of the Estate of Mary Jane Little, deceased. Mary Jane Little, who died on or about September 10, 1953, a resident of Los Angeles County, State of California, filed her Federal income tax returns for the years here

involved in the office of the Collector of Internal Revenue (or District Director of Internal Revenue) at Los Angeles, California. [Tr. 19.]

On July 1, 1955, petition was filed in the Tax Court of the United States (Docket No. 58688) for redetermination of deficiencies in tax asserted by respondent. [Tr. 3.] Decision of the Tax Court was rendered July 21, 1958. [Tr. 5.] The cause comes to this Court upon petition for review filed September 30, 1958. [Tr. 5.] Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

Questions Presented.

The ultimate issue presented by this appeal is whether decedent, Mary Jane Little, was entitled to claim a portion of certain deductions for depreciation and depletion allowable for the taxable years here involved, under subsections 23(l) and 23(m) of the Internal Revenue Code of 1939[1] or, whether the trustee of a testamentary trust of which decedent was a life income beneficiary, was entitled to claim the entire amount of such deductions.

The questions presented arise from the Tax Court's interpretation and application, under stipulated facts, of two identical sentences appearing in the cited subsections. Each provides that "in the case of property held in trust the allowable deduction shall be apportioned between the income beneficiary and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allowable to each."

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[1]All section references herein are to the Internal Revenue Code of 1939 unless otherwise noted.

The subsections of the Internal Revenue Code establish precise rules for the apportionment of the allowable deductions. They are either:

(1) To be apportioned in accordance with the pertinent provisions of the *instrument creating the trust,* or

(2) Absent such pertinent provisions, they are to be apportioned on the basis of the *trust income* allocable to income beneficiaries and trustee respectively.

Although the Tax Court properly found as a fact that "the will made no mention of the treatment of depletion and depreciation deduction as between income beneficiaries and the trust" [Tr. 30], it held that the entire amounts of such deductions were allowable only to the trustee. To reach this conclusion the Tax Court went outside the provisions of the will, *i.e.,* the "instrument creating the trust." Resorting to the provisions of an instrument to which the testatrix was in no sense a party, it held that the testamentary trust must be regarded as modified by a trust agreement entered into by various beneficiaries in settlement of differences between them respecting their own interests in the testamentary trust estate.

The Tax Court's decision gives rise to the following subsidiary questions of law.

(1) What is meant by "pertinent provisions of the instrument creating the trust" as those words are used in subsections 23(l) and 23(m) of the Internal Revenue Code?

(2) Where the provisions of a testamentary trust confer an unqualified discretion on the trustee thereof to determine "what portion of receipts of the estate shall be allocated to corpus of the estate, and what portion of

such receipts shall be allocated to income of the estate," does a contractual undertaking by such trustee, in an instrument to which the testatrix was not a party, that the trustee will exercise its discretion in accordance with provisions of a Texas statute, have the effect, as a matter of Federal income tax law, of incorporating the provisions of the Texas statute in "the instrument" creating the testamentary trust?

(3) Did the trust agreement entered into by the beneficiaries of the testamentary trust modify the instrument creating the latter or did it, in legal effect, only provide for the future disposition of the personal interests of such beneficiaries in the trust estate?

(4) Even assuming that the answer to (2) above is affirmative, do the provisions of the Texas statute have the effect of apportioning *deductions* for Federal income tax purposes between income beneficiary and trustee or do such provisions have the effect of apportioning *trust income* between income beneficiary and trustee?

(5) Where no mention thereof is made by a testatrix in her will creating a testamentary trust, does the fact that during her lifetime her books and records covering oil operations showed regular, consistent charges for depreciation and depletion constitute an implied provision in such will that federal income tax deductions for such items be apportioned to the trustee in the face of specific provisions in the will that trust income was to be apportioned to income beneficiaries and corpus as the trustee in its unqualified discretion might determine?

Statute and Regulation Involved.

These are set out in the Appendix, *infra*.

Statement.

The facts in the case below were all stipulated as set forth in the Stipulation of Facts [Tr. 19-25] and documentary exhibits referred to therein. There is no dispute as to what the facts are but only as to their legal significance.

Except for certain omissions, which petitioner regards as important, the Tax Court's statement of the primary facts is accurate and will be adopted as petitioner's statement of facts. Where additions to the Tax Court's statement are made by petitioner herein, such additions will be indicated as follows: "(Par. added by petitioner)."

Mary Jane Little died on or about September 10, 1953, a resident of Los Angeles County, California. Decedent filed her Federal income tax returns for the years 1949, 1950 and 1951 with the then Collector of Internal Revenue, and for the year 1952 with the District Director of Internal Revenue for the sixth district of California, Los Angeles, California. The Bank of America National Trust and Savings Association is the duly appointed and acting executor of the Estate of Mary Jane Little, deceased. [Tr. 19.]

Decedent was the mother of Gloria D. Foster, who died on or about July 30, 1943, a resident of Dallas County Texas. For many years prior to her death, Gloria conducted an oil business, owning, operating, developing and maintaining many producing oil and gas leases in the East Texas oil field. At the date of her death in 1943 she owned undivided interests in approximately 84 producing oil wells in this field and in the physical equipment used

in connection therewith. The oil income distributed to Mary Jane Little as beneficiary of the Gloria D. Foster Trust during the years here involved (from which depletion and depreciation deductions here at issue were taken) was derived from these oil properties, or other subsequently acquired similar oil properties. [Tr. 20.]

The last will and testament of Gloria D. Foster, deceased, [Ex. 5-E] was duly probated by order of the County Court of Dallas County, Texas, on August 16, 1943. [Tr. 20.]

The will named L. C. Webster, Sol Goodell and T. A. Knight executors. After providing for a few specific bequests of cash and personal effects, the residue of Gloria's property was devised and bequeathed to L. C. Webster, T. A. Knight and Sol Goodell as trustees. The trust provisions of the will are contained in Article "V" and in this portion of the will said trustees were given broad authority and discretion in connection with the management of the corpus, investments and reinvestments. Paragraph 2 of Article V of the will provided, in part, that the "decision of trustees as to what property is corpus and what property is income of [the] estate, shall be final and binding on all parties at interest hereunder. * * * "

Paragraph 5 of Article V of the will also grants the trustees unqualified discretion in allocating trust receipts to income or corpus. (Par. added by petitioner.)

The will made no mention of the treatment of depletion and depreciation deduction as between income beneficiaries and the trust. Paragraphs 8 and 9 of Article V of the will provided as follows:

8. Out of the net income of my estate I direct that Two Hundred ($200.00) Dollars per month shall be paid to my faithful servant, Eva Culbertson, during her life-

time, and One Hundred ($100.00) Dollars per month shall be paid to my mother-in-law, Mrs. Jeremiah Foster, during her lifetime and thereafter to my sister-in-law, Evelyn Foster, during her lifetime. All other net income from my estate shall be paid to my mother, Mary Jane Little, during her lifetime. If during any calendar year after the calendar year during which I die, while my mother is alive, the net income so paid my mother is less than Twelve Thousand ($12,000.00) Dollars, I direct that at the end thereof trustees pay to her the difference out of the corpus of my estate if she so requests.

9. This trust shall terminate on the date of the death of my mother, Mary Jane Little. On termination of this trust, I direct that all the estate and properties constituting it that are then in the hands of trustees shall pass and vest in fee simple and by trustees shall be conveyed.

(a) one-half to Ann Armstrong Knight, if she then be living, and to her heirs *per stirpes* if she then be dead; and

(b) one-half to Marian Ralston Knight, if she then be living, and to her heirs *per stirpes* if she then be dead. [Tr. 29-30.]

The trustees named in the will accepted the trust and allocated to the corpus of the trust so much of the income of the trust after operating expenses but prior to any deductions for depreciation and depletion as was equal to the amount of depreciation and depletion allowable for Federal income tax purposes with respect to such income. [Tr. 20.]

Decedent, Mary Jane Little, proposed to institute proceedings to contest Gloria's will dated April 19, 1943, relying upon the validity of a prior will dated September 8,

1942. For the purpose of settling the threatened will contest a Contract and Agreement, dated September 20, 1944, was entered into by and between the interested parties. [Ex. 6-F.] The Contract and Agreement provided, in part, as follows: (a) that the purpose of the "contract and agreement is to settle, adjust and compromise all matters in issue or controversy between any and all of the parties hereto;" (b) that the trustees named under Gloria's will (dated April 19, 1943) were to resign as trustees, and others were to be appointed; (c) a trust agreement was to be entered into by all beneficiaries under the will, with changes in the power and duties of the new trustees, and with changes in the rights of the beneficiaries.

Under Section II, heading 16 of the Contract and Agreement of September 20, 1944 [Ex. 6-F], the parties to the dispute confirm and agree to the validity of Gloria D. Foster's will dated April 19, 1943 and to the validity of the probate thereof, further agreeing to defend against any attack upon the will. The testamentary trust was thus recognized as valid for all purposes. (Par. added by petitioner.)

Under the trust agreement which was to be entered into pursuant to the Contract and Agreement of September 20, 1944, the corpus of the testamentary trust under the will was not transferred to the trustee under the trust agreement. Instead the interests, *in futuro,* of the remaindermen of the testamentary trust were to be transferred to said trustee. [Ex. 6-F, Sec. II, heading 6.] (Par. added by petitioner.)

[In lieu of the paragraph in the Tax Court's opinion beginning at the bottom of Tr. p. 31 and ending near the bottom of Tr. p. 32 petitioner submits the following more complete summary of the pertinent portions of the trust agreement referred to therein.]

The trust agreement referred to in the Contract and Agreement of September 20, 1944, was executed by certain beneficiaries of the testamentary trust under date of November 14, 1944. [Tr. 21; Ex. 7-G.] First Parties thereunder were the remaindermen under the testamentary trust. Second Party was Mary Jane Little. Third Party was the Mercantile National Bank at Dallas. (Par. added by petitioner.)

Section I, paragraph 1, of the trust agreement of 1944 recites that First Parties have executed and delivered to the Third Party, as trustee all *their* right, title and interest in the estate of Gloria D. Foster, deceased, vesting or to vest in them under her will of April 19, 1943, except for minor specific bequest items. (Par. added by petitioner.)

Section I, paragraph 4, of the trust agreement of 1944 states:

> "The will grants to the trustees thereunder broad discretion in determining what portion of receipts of the estate shall be allocated to corpus of the estate, and what portion of such receipts shall be allocated to income of the estate, and Third Party in the exercise of such discretion hereby undertakes to make this allocation at all times in accordance with the provisions of law applicable at the time without regard to such discretion so granted by said will." (Par. added by petitioner.)

Section II, paragraph 1, of the trust agreement of 1944 describes the character of the trust therein established as follows:

> "1. The trust created under the aforesaid will of Gloria D. Foster, deceased, will terminate on the

death of Second Party, and it is the intention of the parties hereto that thereupon Third Party shall hereunder come into the possession of and hold legal title to all the estate and properties constituting the net corpus of the trust created under said will at the date of termination of said trust that are then in the hands of trustee under said will." (Par. added by petitioner.)

Section II, paragraph 2 of the trust agreement of 1944 provided that prior to the death of Second Party, the trustee was to hold naked legal title to the interests conveyed to the trustee by First Parties. (Par. added by petitioner.)

The trust agreement of 1944 was executed by the parties. The old trustees under the will resigned and were succeeded by the Mercantile National Bank at Dallas. [Tr. 31.] (Par. added by petitioner.)

After the death of Mary Jane Little, and providing that neither she nor her assignees, heirs, representatives or any person claiming through her attacked the Gloria D. Foster will, then under the new trust agreement one-half of the then corpus of the trust was to be distributed to Ann Armstrong Knight and Marian Knight Rowe in equal shares, or to their heirs *per stirpes,* and the other half of the then corpus of the trust was to be distributed to the heirs, representatives, legatees or assigns of Mary Jane Little. [Ex. 7-G, Sec. II, par. 12.]

On September 30, 1947, a suit was brought in the district court of Dallas County, Texas, by L. C. Webster, Sol Goodell and T. A. Knight, as independent executors of the Estate of Gloria D. Foster, deceased, against Mercantile National Bank at Dallas, as successor trustee of the Estate of Gloria D. Foster, deceased; Mary Jane

Little, Talbot Shelton, and Wharton E. Weems, as owners of one-half of the remainder interest in the estate; J. R. Bower, Jr., Ann Knight Bower, Frederick E. Rowe, Jr., and Marian Knight Rowe, as owners of the other half of the remainder interest in the estate. In their petition [Ex. 8-H(1)] plaintiffs alleged that during the course of their administration they, as executors, had received proceeds from the sale of oil and gas from properties of the estate up to December 1, 1946, at which date the Mercantile National Bank at Dallas commenced collecting such proceeds; that they, as executors, had allocated to the corpus of the estate amounts representing "cost" depletion on oil produced and sold, together with depreciation on facilities, equipment, furniture, fixtures and the like, in accordance with practices employed by decedent, Gloria D. Foster, during her lifetime; that they, as executors, set forth such allocations of proceeds to corpus in their final account filed with the court, and they prayed that the court construe the will, particularly with reference to the meaning of the term "net income" as used therein, so as to approve their final account and to instruct them respecting the matter of what portion of funds in their hands represented net income and what portion was corpus and to discharge them from further liability and responsibility as executors. [Tr. 32-33.]

In their answer [Ex. 8-H(2)] the defendants Ann Knight Bower, J. R. Bower, Jr., Marian Knight Rowe and Frederick E. Rowe, Jr., interposed a cross-action wherein they alleged that the issue of proper allocation of the proceeds of sale of oil and gas between income and corpus after December 1, 1946 by Mercantile National Bank at Dallas, trustee, was also in controversy as between themselves and Mary Jane Little and her assignees. The cross-complainants requested declaratory relief to the ef-

fect that the Mercantile National Bank at Dallas, trustee, be ordered to compute and allocate to corpus depletion based on cost or 27½ per cent, whichever was greater, plus depreciation based on the methods used by decedent, Gloria D. Foster, during her lifetime. The court, by decision dated December 13, 1948 [Ex. 8-H(15)], ordered, adjudged and decreed that L. C. Webster, Sol Goodell and T. A. Knight, as executors of the Estate of Gloria D. Foster, deceased, had properly computed depletion and depreciation and allocated correct and proper amounts to corpus for depletion and depreciation as shown by their final account. The court specifically found, in paragraph VIII of its decision, as follows:

In determining the "net income" of decedent's estate, defendant, Mercantile National Bank at Dallas, as Successor Trustee of the Estate of Gloria D. Foster, deceased, in accordance with the law applicable to said estate at this time, and until otherwise directed by a court of competent jurisdiction, is authorized, required and directed to charge and set aside to corpus reserves for depreciation on oil and gas lease equipment and machinery, and depletion, in the following manner:

(a) Depreciation: A reserve for depreciation on the oil and gas lease equipment and machinery belonging to said estate, commencing December 27, 1946, to be computed in the same manner and according to the same formula as the decedent did during her lifetime and as plaintiffs have done as shown by their final account, which reserve for depreciation shall be deducted from the proceeds

of sales of runs of oil and gas produced by said estate subsequent to December 1, 1946, and set aside to corpus.

(b) Depletion: Out of the proceeds of oil and gas runs produced and sold and to be produced and sold from each oil and gas lease subsequent to December 1, 1946, compute, charge and set aside to corpus 27½% of the gross proceeds of such sales of runs from each lease (but not to exceed 50% of the net income from such lease after deducting the expense and carrying charges on such lease, including depreciation, but not including depletion). [Ex. 8-H (15).]

Consistent with its judgment the court decreed that of the $43,091.91 in custody of the executors, $42,379.96 represented corpus of the Estate of Gloria D. Foster, deceased, and $711.95 was net income of said estate. The executors, having previously paid the former sum to Mercantile National Bank at Dallas, trustee, and the latter to Mary Jane Little, deceased, were discharged and acquitted of all other claims arising out of their administration. [Tr. 35.] Mary Jane Little excepted to the judgment of December 13, 1948, in open court, and gave oral notice of appeal, but this appeal was not perfected by her and the judgment became final. [Tr. 23.]

Sproles & Woodard, certified public accountants, were the accountants who kept the books and records of Gloria D. Foster and prepared her income tax returns. These same accountants continued to keep the books and prepare the income tax returns of the Gloria D. Foster estate and trust after her death during the entire period here in-

volved. The books of Gloria D. Foster, while living, regularly and consistently made a charge against income and set up a reserve for depletion of oil and gas properties and a reserve for depreciation of oil and gas equipment in accordance with the standard accounting principles. Subsequent to her death, the estate and trust have regularly and consistently set aside to corpus a reserve for depletion of oil and gas properties and a reserve for depreciation of oil and gas equipment. Depletion was computed on the basis of "cost" (which was the practice of Gloria D. Foster while living) by the executors and trustees from August 1943 to December 1946, and thereafter the trust has used "percentage" depletion. Deductions for depletion and depreciation were claimed in the Federal income tax returns, throughout, consistent with the books of Gloria D. Foster, and, later, the books of her estate and trust. [Tr. 23.]

In filing income tax returns for the Gloria D. Foster Trust, for the years here involved, the trustees computed and claimed as deductions the full amounts of allowable depletion and depreciation as follows:

Year	Depletion Claimed	Depreciation Claimed
1949	$47,011.47	$2,809.01
1950	47,348.24	2,552.21
1951	52,486.87	3,934.42
1952	52,478.44	4,205.44

Mary Jane Little, deceased, in her income tax returns for the years here involved, claimed a share of the deductions for depletion and depreciation allowable in respect of income of the Gloria D. Foster Trust. This share was computed as follows:

Mary Jane Little—1949
Fiduciary Income
Gloria Foster Trust, Mercantile National Bank, Dallas, Texas

I.	Net Income of Trust for 1949 per Spriles [sic] and Woodard		$ 92,128.02
	Deducted in Determining Net Income:		
	Depletion	$ 47,011.49	
	Depreciation	2,809.01	49,820.50
	Net Income before depletion and depreciation		$141,948.52
	Distributed to Mary J. Little in 1949	$ 77,601.94	
	Additional Amount distributable	10,926.08	
	Total distributable to Mary J. Little 1949	$ 88,528.02	$ 88,528.02
	Percentage of total distributable to Mary J. Little		62.3663%

II. Allocation of Income and of Deductions for Depletion and Depreciation

	Taxable Net Income Before Deductions	Deductions	Taxable Net Income
Mary Jane Little 62.3663%	$88,528.02	$31,071.20	$57,456.82
Other beneficiaries 2.5361%	3,600.00	1,263.50	2,336.50
Trust 35.0976%	49,820.50	17,485.80	32,334.70
Total 100%	$141,948.52	$49,820.50	$92,128.02

III.	Taxable to Mary Jane Little before Expense	$57,456.82
	Less Legal Expense	1,602.09
	Net Taxable	$55,854.73

A similar computation was made for each of the years 1950, 1951 and 1952, except for differences in the percentage of total distributable to Mary J. Little, deceased, in each of those years. [Exs. 10-J, 11-K, 12-L, 13-M.]

It will be observed that in her tax returns Mary Jane Little claimed as deductions a portion of the total allowable deductions based upon the portion of net income of the testamentary trust (before such deductions) which was allocable to her.

The trustee claimed the entire amount of deductions for depreciation and depletion allowable under subsections 23-(l) and 23(m) of the Internal Revenue Code. Respondent, Commissioner of Internal Revenue, approved the deductions claimed by the trustee and disallowed the portions thereof claimed by Mary Jane Little, asserting deficiencies in income tax against Mary Jane Little for the years 1949-1952, both inclusive. [Tr. 12.]

The Tax Court sustained respondent's treatment of the deductions, holding that the "testamentary trust, as modified by a later trust agreement, constitutes the 'instrument creating the trust' within the provisions of subsections 23(l) and 23(m) of the Internal Revenue Code of 1939." [Tr. 27.]

Specification of Errors.

1. The Tax Court erred in sustaining respondent's assertion of deficiencies in income taxes against Mary Jane Little for her taxable years 1949-1952 both inclusive, and in sustaining respondent's disallowance of the deductions for depletion and depreciation claimed by her for such years.

2. The Tax Court erred in holding that the provisions of the trust agreement of November 14, 1944, entered

into by beneficiaries of the testamentary trust under the will of Gloria D. Foster, had the legal effect of modifying the provisions of the testamentary trust and in further holding that as so modified the provisions of the testamentary trust constitute the "instrument creating the trust" within the provisions of subsections 23(l) and 23(m) of the Internal Revenue Code of 1939.

3. The Tax Court erred in holding that incorporation by reference in the trust agreement of November 14, 1944, of the provisions of a Texas statute, had the legal effect of incorporating such statutory provisions in the "instrument creating the trust."

4. The Tax Court erred in holding that the provisions of the Texas Trust Act, Acts 1943, 48 Legis., p. 232, ch. 148, amount to a provision of the trust instrument directing the apportionment of the allowable deductions for depreciation and depletion between income beneficiaries and trustee.

5. The Tax Court erred in holding that the decree of the District Court of Dallas County, Texas in 1948, directing the trustee to allocate portions of the proceeds of sale of oil and gas to income and to corpus, had the effect for Federal income tax purposes of incorporating in the instrument creating the trust a provision apportioning the entire amounts of deductions for depreciation and depletion to the trustee.

Summary of Argument.

A summary of petitioner's argument is presented by the following points of law.

I.

Apportionment of Federal income tax deductions for depreciation and depletion between income beneficiaries and trustees of a testamentary trust is controlled by the provisions of the will creating the trust, if any, and if there be no such provisions, on the basis of the trust income allocable to each.

(a) Provisions of subsections 23(l) and 23(m), Internal Revenue Code and background.

(b) The instrument creating the trust was the will of Gloria D. Foster, not the trust agreement of 1944, to which the testatrix was not a party. The will contained no pertinent provisions apportioning the deductions within the provisions of subsections 23(l) and 23(m). The grant by the will to the trustees of authority to allocate trust receipts to income or to corpus in their uncontrolled discretion does not constitute a directive to apportion deductions under "pertinent provisions of the instrument creating the trust." Testatrix' method of bookkeeping during life does not constitute a directive in her will to apportion the deductions.

(c) As used in subsections 23(l) and 23(m) the term "trust income" means net income after all other deductions but before deductions for depreciation and depletion. The apportionment of deductions made in her returns by Mary Jane Little was in accordance with the provisions of subsections 23(l) and 23(m) of the Internal Revenue Code.

II.

The provisions of the trust agreement of 1944 to which the testatrix was not a party, cannot be read into the testamentary trust so as to incorporate therein, by agreement of the beneficiaries, provisions for the apportionment of deductions under the Federal income tax statute. The trust agreement of 1944 was not the instrument creating the trust; nor did it supersede the testamentary trust so as to cause the new trust to become the trust the deductions for which were to be apportioned. The clear directive of a Federal income tax statute cannot be altered by agreement of the beneficiaries of a testamentary trust. The contractual undertaking of the trustee of the testamentary trust did not constitute a directive in the instrument creating the trust to apportion deductions for Federal income tax purposes.

III.

The decree of the state court of Texas, directing the trustee to apportion trust receipts by setting aside to corpus amounts representing depreciation and depletion, did not, as the Tax Court held, have the effect of incorporating such directive in the instrument creating the trust for Federal income tax purposes.

(a) The Texas Court's decree was based upon the trust agreement of 1944 and not upon the will of Gloria D. Foster. Any other construction of its effect would violate the Texas statute.

(b) The Texas Court by decree could not control the allowability of Federal income tax deductions under the circumstances of this case. For purposes of applying subsections 23(l) and 23(m) of the Federal income tax statute the decree of the Texas Court had the effect of apportioning trust income rather than deductions for depreciation and depletion.

ARGUMENT.

POINT I.

Apportionment of Federal Income Tax Deductions for Depreciation and Depletion Between Income Beneficiaries and Trustee of a Testamentary Trust Is Controlled by the Provisions of the Will Creating the Trust, if Any, and if There Be No Such Provisions, on the Basis of the Trust Income Allocable to Each.

(a) Provisions of Subsection 23(l) and 23(m), Internal Revenue Code and Background.

After providing generally for the allowance of deductions for depreciation and depletion from gross income, subsections 23(l) and 23(m) of the Code prescribe precise rules for their apportionment between the income beneficiaries and trustee of a trust. The applicable sentences in both subsections are identical and read:

> "In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each."

A brief analysis and some discussion of the background of these sentences will be helpful in applying them to the facts of this case.

At the outset the language commands that the deductions shall be apportioned in accordance with the *pertinent provisions* of the *instrument creating* the trust. It then provides that if such *pertinent provisions* are absent, the deductions shall be apportioned on the basis

of *trust income* which is *allocable* to each. The key words, therefore, are:

pertinent provisions
instrument creating
trust income
allocable

The Conference Committee report of the 70th Congress, set forth in the Appendix hereto, and the Commissioner's regulations which adopt verbatim the language of part of the Committee report both reflect the Congressional mandate that the apportionment of the deductions is to be made "in accordance with the pertinent provisions of the will, deed, or other instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income which is allocable to the trustee and the beneficiaries, respectively."

Such language admits of reference to no instrument other than that which creates the trust which produces the trust income against which the deductions are allowable. The choice of providing or not providing a directive with respect to the apportionment of such deductions is conferred only upon the testator or trustor whose instrument *creates* the trust. There is no approval, expressed or implied, of the incorporation of such a directive in the provisions of the trust by any *person* other than the creator of the trust, nor by any *instrument* other than that which *creates* the trust.

Certain of these words have been given judicial attention in what are surprisingly few decided cases, but to our knowledge the instant case presents the first occasion on which a Court has been called upon to decide whether the provisions of an instrument to which the person

creating a trust was not a party can be read into the instrument whereby such trust was created.

The question whether "pertinent provisions" were contained in the instrument creating the trust was considered by the Board of Tax Appeals in *William Fleming, Trustee* (1941) 43 B. T. A. 229, affmd. C. C. A. 5 (1941) 121 F. 2d 7, where distribution of income was entirely within the discretion of the trustee. The Board said:

> "The question here is whether the petitioner, trustee, is entitled to deduct the entire depreciation and depletion that may be allowed on the trust income for the taxable year where the pertinent provisions of the trust instrument do not direct whether the trustee or the beneficiary shall take the deduction, and the distribution of the income is placed *entirely in the discretion of the trustee.* The respondent claims that under section 23(l) and (m) of the Revenue Act of 1934 allowance for depreciation and depletion must be divided, in the absence of *specific trust provisions,* between the trust and the beneficiary on the basis of the amount of income distributed and retained in that year. The petitioner contends that, properly interpreted, the statute awards the allowance only to those to whom the trust income is 'allocable' under the trust instrument and that in the present case the income was in the first instance allocated entirely to the trustee. Distributions made thereafter in his discretion, argues the petitioner, do not alter this result. (Emphasis ours.)
>
> "The statute when properly read in the light of the circumstances attendant on its enactment does not support petitioner's view. Prior to the Revenue Act of 1928 it was held in the case of a trust, the

income of which was currently distributable, that the allowance for depreciation and depletion might not be deducted by the beneficiary but only by the trust, even though it retained no income against which the deduction might be applied. See *United States v. Blow,* 77 Fed. (2d) 141; *Charles F. Grey,* 41 B. T. A. 234, 242. The following provision was thereupon added to section 23(k) and (l) of the Revenue Act of 1928 and made applicable to both depletion and depreciation deductions:

> "'In the case of property held in trust the allowable deduction [for depreciation and depletion] shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provision, on the basis of the trust income allocable to each.'

"The purpose of this change in the law was to eliminate the 'considerable hardship' which was imposed on the beneficiaries under prior law and to secure to them their fair portion of these allowances in proportion to the income distributable to them. See Senate Report No. 960, Revenue Act of 1928, (70th Cong., 1st sess.) p. 20. See also *Sue Carol,* 30 B. T. A. 443, 447, 448; *Sada G. Wilson Blake,* 39 B. T. A. 793.

"The force of these facts in the instant case requires the apportionment of the allowance here in question between the trust and the beneficiary. The single factor which stands out against it is the uncontrolled power in the trustee to determine the amount of income to be distributed in any year. This placing of the trust income under the control of the trustee does not, however, constitute the allocation contemplated by the statute."

In affirming the Board of Tax Appeals the Circuit Court of Appeals specifically observed that the trust instrument granted the trustee "uncontrolled discretion" in the distribution of net income and found no provision in the instrument *requiring* the allocation of any part of trust income or depletion.

The petitioner on appeal argued that the grant of discretion to him amounted to a direction in the instrument permitting him to allocate depletion to himself, as trustee, and having done so the entire deduction was allowable to the trustee. The Circuit Court disagreed, saying:

> "The provision of the Act *requiring* the apportionment of depletion on the basis of the *trust income* allocable to the beneficiary was intended to apply to such situations. The act is mandatory. The fact that the trustee distributed part of the *trust income* to the beneficiary in each of the taxable years here involved conclusively shows that the income distributed was allocable within the meaning of the Act." (Emphasis ours.)

The Circuit Court could not have reached that conclusion of law had it regarded the grant of uncontrolled discretion to the trustee as a *pertinent provision* of the instrument *directing* the apportionment of the depletion deduction.

Some three years later the Seventh Circuit Court of Appeals had occasion to examine the meaning of the expression of the words "pertinent provisions" in *Commissioner v. Netcher* (1944), 143 F. 2d 480. In presenting the issue the Court said at page 485:

> "There was no express provision for a depreciation reserve in the will, but the will did provide:

> "'* * * It being my wish that said real estate * * * shall be held together for the benefit of my entire estate and the beneficiaries thereunder. * * *'"

Admitting that it was put to some struggle to find the above language sufficient to constitute a direction to apportion depreciation deductions to the trustee, the Circuit Court affirmed such a finding in a prior Board of Tax Appeals case *(Newbury v. Commissioner* (1932), 26 B. T. A. 101) even though the Tax Court, in the case *then* before the Circuit Court, had changed its interpretation of the same will and found the same language insufficient.

What is important here is the language of the Circuit Court with respect to the "instrument creating" the trust. The Court said at page 486:

> "In the instant situation, the statute was amended to provide for the use of the depreciation deduction in a contingency where the will *specifically* provides for the depreciation deduction, and also where it fails to so provide. It follows, therefore, that both the Commissioner and the courts *must turn to the will to first determine whether it so provides.* The statute in no way sets up criteria to determine whether a will does or does not so provide." (Emphasis ours.)

The term "trust income" as used in subsections 23(l) and 23(m) can have no acceptable meaning other than net income *before* deductions for depreciation and depletion. It is not the equivalent of "net income" for to adopt such a view would permit the allowance of a double deduction for such items. Statutory "net income" means gross income after all deductions of every kind. (Section 21, I. R. C.) If net income were allocated by a trustee and

thereafter a portion of the deductions already taken by the trustee were apportioned to the income beneficiary, its deduction from the beneficiary's share of "net income" would constitute a double deduction.

Petitioner's view in this regard is supported by the decision of the Board of Tax Appeals in the *Fleming* case, *supra* (p. 231), and the Tax Court in *Fred A. Hubbard, Apartments Trust* (1951) (Mem. Dec.) 10 T. C. M. 25.

(b) The Instrument Creating the Trust Was the Will of Gloria D. Foster, Not the Trust Agreement of 1944 to Which the Testatrix Was Not a Party. The Will contained No Pertinent Provisions Apportioning the Deductions Within the Provisions of Subsections 23(l) and 23(m).

The instrument which created the trust which produced the trust income here in question was the will of Gloria D. Foster, dated April 19, 1943. [Ex. 5-E.] The Tax Courts opinion clearly recognizes this. [Tr. 38.]

The Tax Court also found that "the will made no mention of the treatment of depletion and depreciation deduction as between income beneficiaries and the trust." [Tr. 30.]

By the quoted finding of fact the Tax Court concedes that it could discover no provision *in the will itself* which expressly or specifically constituted a direction to the trustee to apportion out of trust income deductions for depreciation or depletion.

Nor does the Tax Court attempt to find in the will a direction to apportion the allowable deductions to the trustee *via* the provisions of the will giving the trustee uncontrolled discretion to allocate trust receipts to income

or to corpus. Presumably, in this matter, the Tax Court recognizes the rules expressed by the Board of Tax Appeals and the Fifth Circuit Court of Appeals in *Fleming, supra,* and by the Tax Court in *Hubbard, supra,* which hold that the grant by an instrument of such broad discretion does not constitute for purpose of the Federal tax statute a direction to apportion deductions but rather to allocate trust income. The difference, of course, is controlling.

The Tax Court makes a somewhat half-hearted attempt to discern an intent on the part of the testatrix that the trustee provide reserves for depreciation and depletion by a reference to her practice in that regard during her lifetime. [Tr. 43.] It is undeniable, however, that what the testatrix did in keeping her books during her lifetime was one thing, and what she declined to do in her will was quite another. What the Federal tax statute required was that she provide *specifically* for the apportionment of the deductions in her will if she desired it to have that effect. That she did not do so and, quite the contrary, granted uncontrolled discretion to her trustees to decide whether or not to do so is a conclusive indication that she did not intend to provide for any fixed method of apportionment.

This view gains force from the fact that the *Fleming* case involved a Texas trust and was decided in 1941. It must be assumed that her counsel in advising her on the matter were aware of the decision. Further, by odd coincidence, Section 26, of the Texas Trust Act (set forth in part in the Appendix hereto) which became effective on the same day testatrix signed her will, April 19, 1943, provided in part:

> "* * * and the person establishing the principal may himself direct the manner of ascertainment of

> income and principal and the apportionment of receipts and expenses or grant discretion to the trustee or other person to do so, and such provision and direction, where not otherwise contrary to law, shall control notwithstanding this Act."

The Tax Court's finding of a testamentary direction to the trustee to maintain depreciation and depletion reserves from the manner in which testatrix kept her books during life is wholly at odds with what she did, with the cited portion of the Texas Trust Act, and with the clear command of the Federal tax statute. Neither the testatrix' method of bookkeeping nor those of the trustee constitute the pertinent provisions required by the statute. The trustee in the *Fleming* case before the Board of Tax Appeals made a similar argument and was rebuffed in the following words:

> "The argument of the petitioner consists principally in a request that the allowance here in question be governed by his bookkeeping practice, but, against what we deem the plain direction of the statute, his position may not be sustained." (Op. p. 234.)

From the foregoing it is clear that for the purpose of applying subsections 23(l) and 23(m) the instrument creating the testamentary trust contained no provisions directing the apportionment of deductions between income beneficiaries and trustee. To find such provisions the Tax Court was compelled to go outside the will.

(c) As Used in Sections 23(l) and 23(m) the Term "Trust Income" Means Net Income After All Other Deductions but Before Deductions for Depreciation and Depletion. The Apportionment of Such Deductions Made in Her Returns by Mary Jane Little Was in Accordance With Those Subsections of the Internal Revenue Code.

It is significant that subsections 23(l) and 23(m) employ the expression "trust income allocable to each" and *not* "net income allocable to each." Under the Internal Revenue Code the latter term has a precise significance and means "the gross income computed under Section 22, less the deductions allowed by Section 23." (1939 I. R. C., Sec. 21.) Since the statute refers to "trust income" rather than "net income," what is meant by the former?

The question was before the Tax Court in *Fred A. Hubbard Apartments Trust* (Dec. 18076 (M)) 10 T. C. M. 25. The issue was whether the trustee was entitled to the full amount of depreciation allowable on trust property for its fiscal year 1945. The trustee there, as here, contended that the broad powers of management conferred upon it by the trust instrument authorized it to set aside depreciation and hence the entire depreciation deduction could be claimed by the trustee. Respondent contended that there was nothing in the trust instrument "which may reasonably be construed as *directing* the trustee to keep the trust corpus intact by reserving depreciation upon it." (Emphasis ours.) (Op. p. 24.) Respondent after first disallowing the deduction in its entirety subsequently conceded that an allocation of the depreciation deduction

should be made as between trustee and beneficiaries as follows:

Fiscal Year 1945.

(1) Gross income	$18,203.85
(2) Operating expense	7,978.53
(3) Net income before depreciation	10,225.32
(4) Depreciation allowed	2,175.01
(5) Balance of net income	8,050.31
(6) Amount distributed	3,902.50
(7) Amount withheld	$ 4,147.81

The sum of (4) and (7) is $6322.82.

Depreciation was apportioned thus:

$$\frac{6322.82 \times 2175.01}{10225.32} = \text{Depreciation allocable to Trustee}$$

In its opinion (p. 28) the Court referred to "trust income" as being $10,225.32, *i.e.,* gross income after all other charges except depreciation, and approved apportionment on the above basis. In applying this formula the Court said:

> "To distribute the income to the bondholders means the same thing as to allocate income to them within the meaning of section 23(l) in the absence of any *express direction* in the trust instrument as to the handling of depreciation." (Emphasis ours.) (Op. p. 29, citing *Fleming, supra.*)

From the language of the Tax Court in the *Hubbard* case it is apparent that petitioner here correctly computed the amounts of depletion and depreciation apportionable to her and that her returns were correct as filed.

II.

The Provisions of the Trust Agreement of 1944 to Which the Testatrix Was Not a Party, Cannot Be Read Into the Testamentary Trust so as to Incorporate Therein, by Agreement of the Beneficiaries, Provisions for the Apportionment of Deductions Under the Federal Income Tax Statute.

The trust agreement of 1944 was not the instrument creating the trust; nor did it supersede the testamentary trust so as to cause the new trust to become the trust the deductions for which were to be apportioned. The clear directive of a Federal income tax statute cannot be altered by agreement of the beneficiaries of a testamentary trust. The contractual undertaking of the trustee of the testamentary trust did not constitute a directive in the instrument creating the trust to apportion deductions for Federal income tax purposes.

The basic error of law made by the Tax Court is expressed in the following two conclusions:

> "The Foster will trust was modified by the trust agreement of 1944 and it is the Foster will trust as so modified in 1944 that is the 'instrument creating the trust' under which petitioner received the income during all of the years (1949 to 1952, inclusive) that are before us. * * *" [Tr. 40.]
>
> "The trust agreement of 1944, by reference to 'the law applicable at the time,' in paragraph 4, makes the foregoing statutory law of Texas a part of the agreement. It amounts to a provision of the trust instrument directing the apportionment of the allowable deductions between the income beneficiaries and the trustee, and the apportionment must be made in accordance with such provisions." [Tr. 41.]

The Federal tax statute refers specifically to the "instrument *creating* the trust." It does not refer to provisions of the trust generally, nor to provisions of instruments modifying or otherwise dealing with the trust or the interests of beneficiaries of the trust.

The legislative history, the Commissioner's regulations and the cases all construe the words "instrument creating the trust" as conferring the right to direct or refrain from directing the apportionment of deductions upon the *creator* of the trust. Here that person was Gloria D. Foster.

In the opinion of the Circuit Court in the *Netcher* case the following significant expressions appear:

> "The construction of the will can not be made to turn on its belated effect on the income of a beneficiary of a subsidiary trust." (Op. p. 487.)
>
> "No subsequent statute or tax situation can effect, much less change, the intention of the long deceased testator."

The clear intendment of these remarks is that the testator of a testamentary trust, or the trustor of an *inter vivos* trust alone possesses the statutory right to provide for the apportionment of deductions in the "instrument creating" a trust.

The same Court further suggests that an attempt, even by a proposal for legislation, to extend the right of apportionment to persons other than the creator of the trust might well meet with Congressional refusal by reason of the possibilities of abuse inherent in such situations. (Op. p. 488.)

It requires little effort to imagine the opportunities for tax avoidance afforded by an interpretation of subsections 23(l) and 23(m) which would permit high and low surtax bracket beneficiaries, or tax exempt beneficiaries such as charities, to apportion the deductions among themselves by agreements which *modify* the instrument creating a trust. It must be assumed that Congress advisedly limited the right to direct apportionment of such deductions to the narrow confines of the instrument or document which brings the trust into existence.

The interpretation here given the words "instrument creating the trust" by the Tax Court violates the principle expressed by the Seventh Circuit Court and would open the door to such very abuses.

The Tax Court concedes that the trust agreement of 1944 did not create the trust but modified it. We submit that in legal effect it did no such thing for Federal income tax purposes.

The trust agreement of 1944 [Ex. 7-G], was an agreement whereby, in order to settle their claims against the estate of Gloria D. Foster, the claimants agreed:

(1) To recognize the validity of the will of Gloria D. Foster dated April 19, 1943. [Ex. 6-F, Sec. II, heading 16.]

(2) The trust under the will was recognized as valid and existing and the *remaindermen agreed* to transfer their *future interests* to a trustee, Mercantile National Bank at Dallas. [Ex. 6-F, Sec. II, heading 6; Ex. 7-G, Sec. I, par. 1.]

(3) The parties agreed that prior to the termination of the trust created by the will, the trustee under the trust agreement of 1944 should hold naked title to the interests of the remaindermen under the testamentary trust. [Ex. 7-G, Sec. II, pars. 1 and 2.]

(4) After the death of Mary Jane Little, the properties constituting the testamentary trust estate were to be conveyed not to the remaindermen named in the will but to the trustee under the trust agreement of 1944 who would thereafter:

(a) Distribute one-half to the remaindermen named in the will and one-half to the heirs, representatives, legatees, or assigns of Mary Jane Little, *providing* neither she nor any one claiming through her had attacked the will.

(b) If such attack *were* made, then the entire trust estate was to be distributed to the remaindermen named in the will. [Ex. 7-G, Sec. II, par. 12.]

(5) In exercising the broad discretion granted by the will to the trustee *thereof* to allocate trust receipts to income and corpus, said trustee "undertakes to make this allocation at all times in accordance with the provisions of law applicable at the time without regard to such discretion so granted by the will." [Ex. 7-G, Sec. I, par. 4.]

Far from being a modification of the "instrument" creating the testamentary trust, the trust agreement of 1944, established a naked trust, of which the corpus consisted of the future interests of the remaindermen under the will. These interests the trustee agreed to hold to secure the parties against further attack upon the will.

Though the trust of 1944 had a *res* it was to have no trust estate until the death of Mary Jane Little.

True, the trustee under the testamentary trust *agreed* to exercise its broad discretion in a certain way, *i.e.*, in accordance with the provisions of the Texas Trust Act at the time. But such an agreement made with the several beneficiaries, was not and could not be a modification of the provisions of the testamentary trust. Actually, it constituted nothing more under *either* local or Federal income tax law, than an agreement to allocate *trust income* to income and corpus. The testatrix, Gloria D. Foster, was not a party to the trust agreement of 1944 and the trustee's *own* undertaking, contractually made, cannot in any sense be said to have been pursuant to her direction in the will. The provisions of the instrument *creating* the testamentary trust remained unchanged. Only the *future* interests of the remaindermen and the heirs, legatees, etc., of Mary Jane Little were to be altered.

A careful examination of the trust agreement of 1944 reveals that it did not even purport to modify the will; it was to become effective as a practical matter only after the testamentary trust had terminated. By a side agreement set forth in the trust agreement of 1944 the beneficiaries of the testamentary trust authorized the trustee thereof to *exercise* its discretion in an agreed manner.

Is one to suppose that the decision in *Fleming, supra*, would have been different if the trustee and the beneficiary there had *agreed* that the trustee might set aside reserves for depletion? We think not.

III.

The Decree of the State Court of Texas, Directing the Trustee to Apportion Trust Receipts by Setting Aside to Corpus Amounts Representing Depreciation and Depletion, Did Not, as the Tax Court Held, Have the Effect of Incorporating Such Directive in the Instrument Creating the Trust for Federal Income Tax Purposes.

After the trust agreement of 1944 had been entered into by the beneficiaries of the testamentary trust under Gloria D. Foster's will, a suit was brought by L. C. Webster, Sol Goodell and T. A. Knight as independent executors of the Estate of Gloria D. Foster, deceased. The substance of the issues presented and decree of the Texas court in that suit are set forth in the Tax Court's opinion [Tr. 32-36] and in the statement of facts *ante*. Petitioner has no quarrel with the Tax Court's statement of the facts respecting the suit in the Texas court but submits that the Texas court's decree did not have the legal effect which the Tax Court here gave it.

The Tax Court held:

> "There, the court determined the 'net income' must be determined 'in accordance with the law applicable to said estate at this time' and it in effect stated the applicable law was a direction to the trustee to allocate all depreciation and depletion to the trust." [Tr. 42.]

From the Texas court's decision the Tax Court takes reinforcement for "our view that the settlement agreement and the new trust agreement in 1944 must be considered as an integral portion of the instruments creating the trust." [Tr. 42.]

The effect of the Tax Court's holding is that the decree of the Texas court, directing the trustee to apportion

to corpus trust receipts equivalent to amounts allowable as deductions for depreciation and depletion, incorporated that direction into the instrument creating the trust with the legal consequence, for Federal income tax purposes, that it thereby constituted a pertinent provision of that instrument, apportioning the allowable deductions to the trustee. This, we submit, is erroneous on several grounds.

(a) The Texas Court's Decree Was Based Upon the Trust Agreement of 1944 and Not Upon the Will of Gloria D. Foster. Any Other Construction of Its Effect Would Violate the Texas Statute.

Gloria D. Foster's will was the instrument which brought the testamentary trust into being. That instrument did not contain the direction of the testarix required by the Federal tax statute. Indeed, under its specifically expressed provisions, uncontrolled discretion was conferred upon the trustees thereof to allocate trust receipts to income or corpus as they saw fit. Under Section 26 of the Texas Trust Act such grant of discretion was not only proper but "shall control notwithstanding this Act."

To hold, as did the Tax Court, that the Texas court's decree took authority for the direction from the testatrix will, would do patent violence to the Texas statute.

The Texas court, therefore, could not properly have derived authority for its decree from either the will alone, or the will as construed under the Texas statute, but could properly have done so from the trust agreement of 1944 which *contractually* incorporated the provisions of Section 33 of the Texas Trust Act in the trust agreement by reference. As we have seen, *ante,* that instrument was not the document which created the testamentary trust.

(b) The Texas Court by Decree Could Not Control the Allowability of Federal Income Tax Deductions Under the Circumstances of This Case. For Purposes of Applying Subsections 23(l) and 23(m) of the Federal Income Tax Statute, the Decree of the Texas Court Had the Effect of Apportioning Trust Income Rather Than Deductions for Depreciation and Depletion.

By whatever authority outside the will the Texas court had the power to direct the testamentary trustee to charge the trust receipts and set aside to corpus, reserves for depreciation and depletion, its decree could not control the allowance of deductions therefor for Federal income tax purposes. It is settled that "state law may control in taxing matters only when the federal taxing act by express language or necessary implication makes its operation dependent upon state law."

Goodwin's Estate v. C. I. R. (1953), 201 F. 2d 576, 580;

Gallagher v. Smith (1955), 223 F. 2d 218, 222.

"Congress establishes its own criteria and the state law may control only when the federal taxing act by express language or necessary implication makes its operation dependent upon state law."

Lyeth v. Hoey (1938), 305 U. S. 188, 194; 59 S. Ct. 155, 83 L. Ed. 119.

In subsections 23(l) and 23 (m) Congress established as the condition for apportionment of deductions solely to the trustee that provision therefor be specifically set forth in the instrument *creating* the trust. Congress likewise prescribed that where such provisions are not so set forth in that instrument the deductions shall follow allocations of trust income to beneficiaries and trustee respectively.

Then, even though the Texas court, under local law, might properly have directed the trustee to set aside to corpus, out of trust receipts amounts to cover depreciation and depletion reserves, its decree had the effect under subsections 23(l) and 23(m) only of directing the allocation of "trust income" between income beneficiaries and trustee respectively. The decree of the Texas court was not a direction by the testatrix, nor did it purport to be such by its terms. Since, as the Seventh Circuit Court of Appeals has held, the Commissioner and courts must look to the will to find the necessary direction, and Gloria D. Foster's will, by the Tax Courts' own finding, made no mention of such direction, the Texas court could not, for the purposes before us, supply it.

Conclusion.

The decision of the Tax Court is erroneous and should be reversed.

Respectfully submitted,

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APPENDIX.

INTERNAL REVENUE CODE OF 1939:

Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

* * * * * * * *

(1) Depreciation.—A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

* * * * * * * *

(m) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but

not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

Regulations 111:

Sec. 29.23(l)-1.

Depreciation. —* * * In the case of property held in trust, the allowable deduction is to be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the will, deed, or other instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income which is allocable to the trustee and the beneficiaries, respectively. For example, if the trust instrument provides that the income of the trust computed without regard to depreciation shall be distributed to a named beneficiary, such beneficiary will be entitled to the depreciation allowance to the exclusion of the trustee, while if the instrument provides that the trustee in determining the distributable income shall first make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the allowable deduction will be granted in full to the trustee. For

deduction with respect to the amortization of emergency facilities, in lieu of the deduction for depreciation, see sections 23(t) and 124.

REPORT—CONFERENCE COMMITTEE.

70th Cong., 1st Sess., H. Rept. 1882.

Amendment No. 30: Under existing law difficulty has been experienced in determining and allowing the deduction for depreciation in cases where property is held by one person for life with remainder to another person; and the deduction, in the case of property held in trust, is allowable only to the trustee. The Senate amendment provides that a life tenant, for the purpose of this deduction, shall be considered as the absolute owner; so that he will be entitled to the deduction during his life, and that thereafter the deduction, if any, will be allowed to the remainder man. In the case of property held in trust, the allowable deduction is to be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the will, deed, or other instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income which is allocable to the trustee and the beneficiaries, respectively. For example, if the trust instrument provides that the income of the trust computed without regard to depreciation shall be distributed to a named beneficiary, such beneficiary will be entitled to the depreciation allowance to the exclusion of the trustee, while if the instrument provides that the trustee in determining the distributable income shall first make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the allowable deduction will be granted in full to the trustee. The bill contains similar provisions as to the deduction for depletion. The

Senate amendment provides for an equitable apportionment of the deduction in these cases; and the House recedes.

TEXAS TRUST ACT.

[Ch. 148—General and Special Laws—Texas 48th Legislature—Reg. Sess. 1943 (pp. 232-247), Effective April 19, 1943.]

Sec. 26. Right of trustee to determine principal and income.

This Act shall govern the ascertainment of income and principal and the apportionment of receipts and expenses between tenants and remaindermen, in all cases where a principal has been established with or, unless otherwise stated hereinafter, without the interposition of a trust; except that in the establishment of the principal, provision may be made touching all matters covered by this Act, and the person establishing the principal may himself direct the manner of ascertainment of income and principal and the apportionment of receipts and expenses or grant discretion to the trustee or other person to do so, and such provision and direction, where not otherwise contrary to law, shall control notwithstanding this Act.

Sec. 27. Income and principal—disposition.

* * * * * * * *

c. All income after deduction of expenses properly chargeable to it, including reasonable reserves, shall be paid and delivered to the tenant or retained by him if already in his possession or held for accumulation where legally so directed by the terms of the transaction by which the principal was established; while the principal shall be held for ultimate distribution as determined by the terms of the transaction by which it was established or by law.

Sec. 31. Principal used in business.

When principal is used in business, the net profits and any increase or decrease in the principal shall be allocated as follows:

* * * * * * * * *

c. Where such business does not consist of buying and selling property, the net income shall be computed in accordance with the customary practice of such business, but not in such a way as to decrease the principal.

Sec. 33. Disposition of natural resources.

Where any part of the principal consists of any interest in lands, including royalties, over-riding royalties, and working interest, from which may be taken timber, minerals, oil, gas, or other natural resources and the trustee or tenant is authorized by law or by the terms of the transaction by which the principal or trust was established to sell, lease, or otherwise develop such natural resources, and no provision is made for the disposition of the net proceeds thereof after the payment of expenses and carrying charges on such property, such proceeds, if received as extension payments on a lease or bonus of consideration for the execution of the same, shall be deemed income, but if received as consideration, whether as royalties or otherwise, for the permanent severance of such natural resources from the lands, shall be apportioned to principal and income as follows:

Such percentage thereof as is permitted to be deducted for depletion under the then existing laws of the United States of America for federal income tax purposes shall be treated as principal and invested or held for the use and benefit of the remainderman, and the balance shall be treated as income subject to be disbursed to the tenant or person entitled thereto, or if no provision for such de-

duction for depletion is made by the then existing federal income tax laws, then twenty-seven and one-half (27½%) per cent of the net proceeds thereof each year shall be treated as principal and invested or held for the benefit of the remainderman and the balance shall be treated as income and subject to be disbursed to the tenant or person entitled to such income. Such disposition of proceeds shall apply whether the property is producing or non-producing at the time the trust becomes effective.

[Ch. 77—General Laws—Texas 49th Legislature—Reg. Sess. 1945 (pp. 109-114).]

Sec. 9. Section 26 of Senate Bill No. 251, Acts of 1943, 48th Legislature, Chapter 148, is hereby amended so that the same shall hereafter read as follows:

Section 26. Right of Trustee to Determine Principal and Income.

This Act shall govern the ascertainment of income and principal, and the apportionment of receipts and expenses between tenants and remainderman in all cases where an express trust has been created; except that in the establishment of the principal, provision may be made touching all matters covered by this Act, and the person establishing the principal may himself direct the manner of ascertainment of income and principal and the apportionment of receipts and expenses or grant discretion to the trustee or other person to do so, and such provision and direction, where not otherwise contrary to law, shall control notwithstanding this Act.

Sec. 10. Section 33 of Senate Bill No. 251, Acts of 1943, 48th Legislature, Chapter 148, is hereby amended so that the same shall hereafter read as follows:

Section 33. Disposition of Natural Resources.

Where any part of the principal consists of any interest in lands, including royalties, overriding royalties, and working interest, from which may be taken timber, minerals, oil, gas or other natural resources, and the trustee or tenant is authorized by law or by the terms of the transaction by which the principal or trust was established to sell, lease, or otherwise develop such natural resources, and no provision is made for the disposition of the proceeds thereof, such proceeds, if received as delay rentals on a lease shall be deemed income, but if received as consideration, whether as bonus or consideration for the execution, of the lease or as royalties, overriding or limited royalties, oil payments or other similar payments, received in connection with the physical severance of such natural resources, shall be apportioned to principal and interest as follows: 27½% of the gross proceeds (but not to exceed 50% of the net, after deducting the expenses and carrying charges on such property) shall be treated as principal and invested or held for the use and benefit of the remainderman, and the balance shall be treated as income subject to be disbursed to the tenant or person entitled thereto. Such disposition of proceeds shall apply whether the property is producing or non-producing at the time the trust becomes effective.